Germany:
Pre-2004 thin capitalization rules violate nondiscrimination principle in relation to Switzerland

Germany’s Federal Tax Court (BFH) recently ruled on whether the pre-2004 thin capitalization rules were compatible with the nondiscrimination principle in Germany’s tax treaty with Switzerland. The European Court of Justice (ECJ) held in its 2002 decision in the Lankhorst-Hohorst case that the thin capitalization rules were incompatible with the freedom of establishment principle in relation to EU/EEA countries, but in 2007 the ECJ concluded in Lasertec that the rules were in compliance with the free movement of capital principle in relation to third countries.

The BFH has now held that, under the pre-2004 thin capitalization rules, German companies with Swiss resident shareholders were subject to taxation that was more burdensome than that of a similar German company with German resident shareholders, and this constitutes an infringement of the nondiscrimination principle in the Switzerland treaty. The fact that the treaty does not include a provision similar to article 24(4) of the OECD Model Treaty, which excludes payments made to nonresident shareholders from the application of the nondiscrimination principle, appeared to be an important factor in the BFH’s analysis.

Although the German thin capitalization rules were extended to cover domestic situations as from 2004 following the Lankhorst-Hohorst decision and were completely revised and modified as from 2008, the decision still may be relevant. For example, it may be important in tax audit cases for years before 2004 where the thin capitalization rules are still applied in relation to Swiss shareholders (the applicability to other third country taxpayers would need to be analyzed on a case-by-case basis as it would depend on the actual wording of the applicable treaty (potentially relevant for countries such as Canada or Japan)). It remains to be seen whether the decision will have more far-reaching effects in other nondiscrimination cases where ECJ principles could be extended to third countries based on the BFH decision (e.g. potentially in the case of the old higher tax rate for permanent establishments).

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